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IN THE

Supreme Court of the United States

October Term, 1973

No. 73-517

EARL VEST AND FAY VEST,
Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1973

No.

EARL VEST AND FAY VEST,
Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

TO: THE HONORABLE WARREN BURGER, CHIEF JUSTICE OF THE UNITED STATES AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES.

By this Petition, Earl Vest and Fay Vest, respectfully seek a writ of certiorari to review part of the judgment and opinion in this case of the United States Court of Appeals for the Fifth Circuit.

I. OPINIONS OF THE COURTS BELOW.

The trial court, the United States Tax Court, made findings of fact and rendered its opinion which are reported in 57 TC 128, involving four separate and unrelated issues, only two of which were appealed and only one of which is the subject of this Petition. In view of the length of the Tax Court findings and opinion which do not relate to the issue here presented, and the orderliness thereof, only the germane portions of the Tax Court's findings of fact and opinion are reproduced as Appendix "A" appended hereto. The opinion of the Court of Appeals is appended hereto as Appendix "B". It is reported in ____ F.2d ____.

II. JURISDICTIONAL STATEMENT.

The judgment sought to be reviewed, reproduced as Appendix "C" hereto, was entered on June 22, 1973. The order denying a rehearing was entered on August 8, 1973, and is set forth as Appendix "D". The statutory provisions believed to confer on this Court jurisdiction to review the judgment in question is Section 1254 of Title 28, United States Code.

III. QUESTION PRESENTED.

Is the right to be paid for a natural deposit (in this case, water rights in certain lands), a "retained economic interest", if the payments are measured by water sold or used from or transported across properties in which the seller owned nothing, and in which the buyer might not have any ownership? The Tax Court

held that such a right of payment is not a "retained economic interest", and the Court of Appeals, at the urging of neither party, held that it is.

IV. LAWS AND REGULATIONS WHICH THE CASE INVOLVES.

The "economic interest" concept is one which is used to determine a number of important income tax consequences. In this case, "retained economic interest" classification determines whether payments for property sold are to be deemed proceeds from the sale of a capital asset, or are ordinary income. Another use of the concept is to determine who may be entitled to depletion allowances, and in this regard the Treasury Department, in 1960, adopted a definition of "economic interest" in Treasury Regulations Section 1.611-1(b) (1), as follows:

> Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a

> mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

This Regulation was amended in 1973 to incorporate an exception made by the adoption of Section 636 in 1969, pertaining to production payments as economic interests.

V. STATEMENT OF THE CASE.

This is an income tax case initiated by Petitioners in the United States Tax Court under the authority of Sections 7442 and 6213 of Title 26, United States Code.

In 1963, by Warranty Deed, Petitioners sold to Shell Oil Company water rights in certain underground strata, in certain lands in Winkler County, Texas, in perpetuity, without any requirement that Shell do, or not do, anything with them. Petitioners did exact from Shell the duty to pay the purchase price therefor, if, as and when due. Petitioners excepted from the conveyance water required for use in exploration and production of minerals from those lands (an exception which Respondent does not regard as consequential.

Rev. Rul. 73-341, IRB 1973-34, p. 22) (App. 94-96). With the water rights, Petitioners sold an easement across the land for one trunk water pipeline (App. 96), and granted Shell an option to purchase other water line easements (App. 78).

While the water right and easement grants were in perpetuity (App. 94-97), the right to be paid was not. Rather, the right to be paid was limited to 75 years (App. 79). The purchase price payments were to be computed in relation to the amount of "purchase price water" that is (1) produced from the water rights conveyed; (2) water transported using the trunk water line easement granted by Petitioners'; (3) water produced from other lands in which Shell acquired water rights in Ector, Ward and Winkler Counties, Texas, in April, 1963; (4) water transported by Shell using other easements acquired in April, 1963; (5) under certain conditions, water produced from water rights already owned by Shell; (6) water produced from water rights which Shell might later acquire; and (7) water transported by Shell in the county, either gratuitously or for hire. The payments are based on Shell's sales price of the water to an ultimate user or the value of water used by Shell, at the ends of its pipelines, not on wellhead values, and on transportation charges made for water merely transported by Shell, and if such are less than specified amounts, those specified amounts per barrel are used in the computation (App. 76, 80-83). In effect, to finance its acquisition of the fee water rights, and easements, Shell afforded Petitioners an economic advantage by agreeing to pay Petitioners for 75 years a portion, which might

exceed 100%, of the future revenues it might derive from the conduct of water sale, use and transportation businesses conducted in and about Winkler, Ward and Ector Counties, Texas.

Shell has never drilled wells or removed water from Petitioners' land nor has it laid pipelines on Petitioners' land (Stipulation of Facts, page 93). The purchase price payments for the tax years in question, of necessity, derived from water rights and Shell's efforts as a transporter and seller or user of water, in none of which did Petitioners ever have an investment.

Petitioners reported to the Internal Revenue Service all Shell payments as proceeds derived from the sale of capital assets, in the belief that they had retained no "economic interest" in the water right deposits. Respondent claimed the proceeds are ordinary income, not because Petitioners had retained an "economic interest", but because, in Respondent's opinion, the "economic interest" test should not be decisive of the capital gain - ordinary income dichotomy in water right cases.

VI. REASONS FOR GRANTING THE WRIT.

For more than 25 years, those involved in natural deposits in place transactions have been laboring under the limitation thought to have been imposed by *Anderson vs. Helvering*, 310 U.S. 404 (1940), and surely imposed by *Charles Burke*, 5 T.C. 1167 (1945), that to qualify as a "retained economic interest", its holder, for the return of his investment, must solely rely on

production from the property interest that he had conveyed, and in which he had kept his retained rights. Under these cases the ability to be paid from any other source, even production from another undivided interest in the same natural deposit in the same tract of land, is fatal to classification as a "retained economic interest".

The Court of Appeals below has said otherwise, holding that taxpayers have a "retained economic interest" in a transferred water deposit in given lands as long as their right to payment is inextricably linked to water, no matter that such water was neither produced from nor transported across lands in which the taxpayers had ever had an investment or other interest.

This distinction is critical to everyone dealing in natural deposits in place. If the Court of Appeals is correct, then *Charles Burke* is inoperative, its interpretation of *Anderson vs. Helvering* is too narrow, and, following the consequences flowing from the economic interest concept, there emerge new and important opportunities to shift risks and undesirable income tax consequences. If the Court of Appeals is wrong, and *Anderson vs. Helvering* and *Charles Burke*, taken together, are expressive of the law, all having business in natural deposits should like to know it before reliance on the holding of the Court of Appeals is misplaced. The interpretation of *Anderson vs. Helvering* made in *Charles Burke*, and the opinion of the Court of Appeals cannot coexist together, either one or the other expounds a basic fundamental of income taxation of a basic and fundamental segment of industry.

VII. ARGUMENT.

The "retained economic interest" test is being used to determine whether payments made in a given transaction in a natural deposit in place are to be classified as subject to capital gain taxation, or as ordinary income, subject to depletion if authorized. See *Wood vs. U. S.*, 377 F.2d 300 (C.A. 5, 1967), and the cases from the other circuits following its lead.[1] If an economic interest is retained, payments are generally regarded as ordinary income. If the right to payment is not classified as a "retained economic interest", the transaction may qualify for capital gains taxation.[2] The economic interest concept is also used to determine who must report income on the receipts from production,

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[1] *Royalton Stone Corp. vs. C.I.R.*, 379 F. 2d 298 (C.A. 2, 1967); *Schreiber vs. U.S.*, 382 F. 2d 553 (C.A. 7, 1967); *Hair vs. C.I.R.*, 396 F. 2d 6 (C.A. 9, 1968); *Alkire vs. Riddell*, 397 F. 2d 779 (C.A. 9, 1968); *Gitzinger vs. U.S.*, 404 F. 2d 191 (C.A. 6, 1968); *Belknap vs. U.S.*, 406 F. 2d 737 (C.A. 6, 1969); *Oliver vs. U.S.*, 408 F. 2d 769 (C.A. 4, 1969); *Hartman Tobacco Company vs. U.S.*, 471 F. 2d 1327 (C.A. 2, 1973), en banc, overruling *Barker vs. C.I.R.*, 250 F. 2d 195 (C.A. 2, 1957); *Don C. Day*, 54 T.C. 1417(A) (1970).

[2] Outside of the oil and gas field, the decided cases since the *Wood* decision have not focused on the nature of the initial payment made in transactions in which the retained interest is a production payment, i.e., a right to payment from production which is of shorter duration than the life of the interest transferred. *Thomas vs. Perkins*, 301 U.S. 655 (1937), which provided a cornerstone for the ABC transaction, treats such a transaction as a sale, so that the initial consideration may be taxed as capital gain. Section 636 of Title 26, U.S.C., enacted in 1969, to denude conventional production payments of their status as economic interests, while destroying the effectiveness and desirability of the use of production payments in the ABC transaction, does not purport to change the rule of *Thomas vs. Perkins* as it affects the ordinary income-capital gain dichotomy.

who is entitled to depletion, the deductibility, and who is entitled to it, of intangible drilling expenses and operating costs, and the need to capitalize costs of acquisition of deposits in place. The concept is said to be the bedrock on which any understanding of mineral tax law is built. See *Sneed, the Economic Interest - An Expanding Concept,* 35 Tex. L.R. 307, 308 (1957).

The term "economic interest" first appeared in *Palmer vs. Bender,* 287 U.S. 551 (1933), in which the court determined that the requisites of an economic interest are: (1) that the taxpayer has acquired by investment an interest in the mineral in place, and (2) secured by legal relationship, income from the extraction of minerals to which he must look for the return of his capital. The second factor has been interpreted to mean that the taxpayer must look solely to the extraction of the mineral for a return of his capital. *Commissioner vs. Southwest Exploration Co.,* 350 U.S. 308 (1956), citing *Anderson vs. Helvering,* 310 U.S. 404 (1940).

In 1938, in *Helvering vs. Bankline Oil Co.,* 303 U.S. 362 (1938), Mr. Chief Justice Hughes invented the phrase "economic advantage" derived from production of a mineral, as distinguished from an "economic interest", which is applicable to situations in which the person in question had no interest in the mineral in place, i.e., had no capital investment in the mineral deposit. This distinction Respondent recognized in promulgating Treasury Regulation Section 1.611-1 (b) (1). This distinction forms the basis for the holding

that a "bare right measured by production does not constitute an economic interest" as made in *Commissioner vs. Remer*, 260 F.2d 337, 340 (C.A. 8, 1958), affirming 28 T.C. 85 (1957).

Anderson vs. Helvering, decided in 1940, involved the sale of oil and gas rights in which the seller was to receive one-half of the production from the interest sold until a specified amount was received, either from production or the sale of the fee interest in the surface and mineral estates. The right to look to the sale of the fee was held by the Court to deprive the production payment of its status of an economic interest since the seller was not solely dependent on the production for the return of his investment. This had the effect of causing the buyer, rather than the seller, to be taxable on the income from the one-half of production that was retained throughout the payout and, following suit, resulted in the treatment of the proceeds as derived from the sale of an asset which may be subject to capital gain.

In 1945, the Tax Court, in *Charles Burke*, had before it a situation in which a seller, Signal Hill, sold and conveyed an undivided 4/24ths interest in the Fred Lee lease to the Burkes who already owned another undivided interest in the lease, and in exchange therefor, the buyers granted to the seller a production payment payable from an undivided 7/24ths of production from the lease. The issue was whether the seller had retained an economic interest in the fractional interest sold. The government claimed, and the Tax Court held, that *Anderson vs. Helvering* applied to prevent the sel-

ler's interest in production from qualifying as an economic interest because of the seller's ability to resort to a larger share of production than the seller had had, even though it was in the same type of production, from the same deposit and even from the same lease. As a result, the buyer was held to be taxable on all of the income that went to the seller attributable to the production payment. These payments would, of course, need also to be capitalized by the buyers.

In *Standard Oil Company (Indiana) vs. Commissioner*, 465 F.2d 246 (C.A. 7, 1972), the Court of Appeals for the Seventh Circuit also interpreted the "solely out of production" limitation of *Anderson vs. Helvering* as relating "to assets other than the specific rights transferred", 465 F.2d, at 351.

Commentators have also been teaching that *Anderson vs. Helvering* and *Charles Burke* cause destruction of economic interest status if the holder of the right in question may look to assets for the return of his investment other than the specific rights transferred. See *Hogan, The Tax Implications of Certain Transactions Involving Oil and Gas Interests Which Should Be Recognized By The General Practitioner*, 7 Rocky Mountain Mineral Law Institute (1962), 613, 637; *Berger, Taxwise Drilling and Financing of Wells*, 6th Annual Southwestern Legal Foundation Institute on Oil and Gas Law and Taxation, 505, 518; *4 Mertens, Law of Federal Income Taxation*, Sec. 24.60, p. 330.

If, from their tract of land, Petitioners have retained an economic interest in Shell's water business, the income tax consequences of their 1963 transaction with

Shell which follow are (1) Petitioners are taxable at ordinary income rates on that which Shell pays them and presumably are entitled to amortize their adjusted cost basis, if any, in the assets sold over the 75 year payout; and (2) Shell may exclude from its gross income from its water business the amounts paid to Petitioners, and is to be required to capitalize nothing paid for its acquisition of Petitioners' water rights. If Petitioners' right to payment from Shell is not a "retained economic interest", (1) Petitioners are required, as they have done, to report all receipts derived from Shell as long-term capital gain; and (2) Shell must include in its gross income all receipts derived from its water business as ordinary income, may not deduct therefrom the amounts paid to Petitioners, and must capitalize all amounts paid to Petitioners. Shell's recovery of its capitalized costs may not be amortized because its rights are perpetual and because the productive life of the property presumably is indeterminable due to recharge factors. Even in dealing in natural deposits for which there are statutory depletion allowances, capitalization of costs of acquisition is generally wasted on the taxpayer until the properties are sold, and is to be avoided if at all possible.

Anderson vs. Helvering and *Charles Burke* have served to curb transactions in which capitalization of leasehold acquisition costs may be avoided inasmuch as most owners of valuable natural deposits are unwilling to either lease or sell the same without an assured payment of some sort, and, in leasing transactions, one that is subject to statutory depletion allowances. Higher bracket taxpayers, in handling more valuable mineral deposits, tend to prefer to receive

deferred, assured payments to keep such amounts out of the higher tax brackets. However, in leasing transactions, they find that the familiar installment payment election of Section 453 (b) of Title 26, U.S.C., does not apply, and that a deferred bonus arrangement and any effort to obtain capital gain treatment thereof may be hazardous in view of *Cowden vs. Commissioner*, 289 F.2d 20 (C.A. 5, 1961).

If the Court of Appeals below is correct that one retains an economic interest in a natural deposit that is transferred to another as long as payment is inextricably linked to production of the same generic class as that which may be attributed to the transferred natural deposit, unless the consequences following from ownership of economic interests are changed, no imagination is required to conceive of how transactions may be made to eliminate or alleviate the undesirable tax strictures which have heretofore existed. By dealing so that little or no cash is paid on consummation, and by the retention by the seller of a royalty or an overriding royalty, of which includes a fraction of production from other known reserves with predictable producing capacity of the same generic class, the practical considerations of both the buyer and the seller stand to be solved without tax disadvantages to either. Those with retained economic interests, such as the royalty or overriding royalty measured by two or more properties, having tax brackets which are, or become too high to permit of their continued ownership, may sell at capital gain all or any undivided part of their royalty or overriding royalty in a sale transaction (which might qualify under the installment sale provisions of the Code) in favor of a lower bracket

taxpayer. See *U.S. vs. Witte*, 306 F.2d 81, 88 (C.A. 5, 1962). Thus, the ABC type of transaction becomes revived, and even made to work in the leasing of properties which are not yet productive.

CONCLUSION

The Court of Appeals has surely reached a significant conclusion affecting the modes of dealing in natural deposits and the financing thereof. Petitioners believe the Court of Appeals to be in error, that *Anderson vs. Helvering* is to the contrary, that the Tax Court below and in *Charles Burke* was correct, and that Petitioners, in their 1963 transaction with Shell, properly relied on *Anderson vs. Helvering* and *Charles Burke*. In either event, the conflict needs final resolution, before further reliance on either line of cases proves to have been misplaced.

Respectfully submitted,

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APPENDIX "A"

57 T. C. No. 13
UNITED STATES TAX COURT

EARL VEST and FAY VEST, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 3726-69 Filed October 28, 1971.

1. All the stock of V corporation was exchanged for stock of S corporation. At the time, V's sole asset was a lease on oil and gas underlying a portion of petitioner's land. The lease had been acquired upon the organization of V from petitioners through a revocable trust of which petitioners were settlors and beneficiaries. Prior to the organization of V, petitioners and S had unsucessfully attempted to arrange an exchange of the minerals for a ranch. Petitioners had V corporation organized for the purpose of developing the mineral interests and to correct or alleviate certain title problems in the interests. When V was organized, the petitioners had no knowledge of a possible exchange of V stock for S stock. Held, V was organized for a business purpose, and was not a step in an integrated transaction to exchange a mineral interest for stock; thus the exchange of V stock for S stock was nontaxable within the meaning of sec. 354(a) (1) since a sec. 368(a) (1) (B), I.R.C. 1954 reorganization had taken place.

2. During 1966, S corporation paid petitioners amounts with respect to roads, flowlines, and well and tank battery locations on petitioners' land. The a-

mounts were paid under the terms of an oil and gas lease which remained in effect as long as oil and gas continued to be produced. *Held,* the amounts received were in the nature of rent and taxable as ordinary income.

3. Petitioners, in 1965, paid a $20,000 fee to the trustee of their revocable trust, and claimed the entire amount as a deduction. *Held,* fee allocated among legal fees and trustee expenses, deductible under sec. 212, I.R.C. 1954, and expenses incurred for the benefit of V corporation which are capital in nature and nondeductible.

4. In 1965, 1966, and 1967, petitioners received certain payments under a water rights agreement with Shell. The payments were not made out of production from the deposit conveyed. *Held,* petitioners did not retain an economic interest in the water in place, the agreement constituted a sale and amounts received under the agreement are taxable as capital gain.

STERRETT, *Judge:* Respondent determined the following deficiencies in petitioners income taxes for the indicated years:

Year	*Deficiency*
1965	$762,913.92
1966	13,561.30
1967	3,863.48

This case presents the Court with four questions for determination:

1. Whether petitioner received certain shares of Standard Oil Company of California as part of a tax-free corporate reorganization or as a lease bonus or advanced royalty on an oil and gas lease, in 1965.

2. Whether $33,422 received by petitioners during 1966, from Standard of California with respect to roads, flowlines, well locations and tank batteries located on petitioners' ranch is taxable as ordinary income or as capital gain received for the sale of a surface easement.

3. Whether the amount of $20,000 paid in 1965 under a fee agreement with a trustee of a revocable trust established by petitioners constitutes an ordinary and necessary business expense.

4. Whether an agreement between petitioners and Shell Oil Company was a disposition of water rights and a perpetual easement such that payments made pursuant to the agreement in 1965, 1966 and 1967 constitute capital gain, or whether the agreement was instead a lease of water rights generating ordinary income.

FINDINGS OF FACT

Earl Vest (hereinafter referred to as Earl) and Fay Vest are husband and wife (hereinafter collectively referred to as petitioners). At the time of filing their petition herein they resided in Monahans, Texas. They filed their joint Federal income tax returns for the taxable years 1965, 1966, and 1967 with the district dir-

ector of internal revenue, Dallas, Texas. Petitioners have one son named Sam Vest (hereinafter referred to as Sam). Sam and the petitioners will hereinafter be referred to collectively as the Vests.

* * * *

The final question arises by reason of the petitioners' reporting in each of their income tax returns for the taxable years 1965, 1966, and 1967, the following amounts as having been received on the sale or exchange of "water rights":

Year	*Amount*
1965	$4,545.80
1966	11,278.64
1967	10,806.51

Petitioners claimed no basis in the "water rights" and treated the entire amounts received as capital gain.

The amounts received were paid to petitioners by Shell Oil Co. (hereinafter referred to as Shell). The payments were made pursuant to an agreement between petitioners and Shell contained in two documents referred to as "Sales Agreement" and "Conveyance" both dated April 29, 1963 (hereinafter referred to as the water agreement).

Under the water agreement, Shell received "[A]ll the water rights between the depths of 3,000 and 6,500 feet beneath the surface * * *" of certain described lands belonging to petitioners in Winkler County, Tex-

as, known as the Hallie Ranch. Petitioners, however, reserved the right to "[W]ater necessary or required in connection with the exploration for and production of other mineral * * *" covered by the agreement. Shell also acquired a right-of-way over the subject lands to operate a trunk pipeline for the transportation and distribution of water, along with the right of ingress and egress to such line and for the purposes of developing the water rights. The agreement stated that Shell's purpose in acquiring the water rights was "primarily to obtain sufficient reserves" of water for use in secondary recovery of oil by means of water flood.

The total amount to be paid petitioners under the water agreement was referred to as the "purchase price" and was defined as the remittance of the monthly payment provided for in the water agreement each month through December 2038. The monthly payments were to be determined according to the amount Shell received for "purchase price water." Purchase price water was defined as water produced from the water rights petitioner had transferred to Shell or from other water rights acquired by Shell from others in Winkler, Ward and Ector Counties, Texas, during April 1963, or from other specified areas of Winkler County that might be brought under the agreement at a latter time, or any water, not otherwise covered by the agreement, transported through pipelines constructed pursuant to the agreement. Each monthly installment was to equal 13-1/6 percent of 3 percent of what Shell received for purchase price water during the month until 1.4 billion barrels of water were covered by the agreement

then the amount due would rise to 13-1/6 percent of 6 percent of purchase price water. Shell was not required to pay a certain fixed amount, regardless of whether water production and transportation were discontinued, and did not assure petitioners that payments under the water agreement would equal any fixed dollar amount.

The water agreement gave Shell the option, if "purchase price water" were to fall below an average of 50,000 barrels per day for 6 months, to be relieved of any further liability to pay the "purchase price" by transferring the acquired water rights back to petitioners. If the water rights are transferred back to petitioners under these circumstances, Shell thereafter had the option of acquiring the right to transport substances other than water through any pipeline laid under the agreement by paying petitioners $10 per rod of pipeline.

From April 29, 1963, the date the agreement was entered into, through the years involved in this proceeding, Shell has not drilled water wells, removed water from petitioners' land, or laid pipelines on petitioners' land. None of the payments made to petitioners pursuant to the agreement during the years 1965, 1966, or 1967 were capitalized by Shell. Shell charged all the payments to "water supply system expense" which is an expense account.

Respondent's position with respect to these issues is stated in his statutory notice dated May 23, 1969. Therein he determined that the entire value of

the 14,000 shares of Standard stock transferred to Ted M. Kerr on September 23, 1965, is includible in petitioners' 1965 income, and that such income constitutes ordinary income.[1] It was also determined in the notice that the $33,422 petitioners received in 1966 with respect to roads, flowlines, well locations and tank batteries was ordinary income and not capital gain as reported by the petitioners. The statutory notice disallowed deduction of the $20,000 trustee fee for the reason that "[T]his amount was paid to the firm of Kerr, Fitz-Gerald and Kerr for services rendered in setting up the trust which was established for * * * [petitioners] benefit." Finally, in the notice respondent determined that the amounts received by petitioners in 1965, 1966 and 1967 pursuant to the water agreement with Shell is ordinary income rather than capital gain.

OPINION

* * * *

The fourth and final matter we must consider is whether an agreement between petitioners and the Shell Oil Company was a disposition of water rights and a perpetual easement such that payments made pursuant to the agreement constitute capital gain, or whe-

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[1] In the statutory notice, respondent valued the Standard stock at $77.875 per share as of the date of transfer, and computed petitioners' gain accordingly. The parties have now agreed that the stock had a value of $71.50 on the date of transfer. Respondent has also agreed that if it is determined by this Court that the Standard stock was received by petitioners as a lease bonus or advance royalty, petitioners will be entitled to a depletion allowance.

ther the agreement was instead a lease of water rights generating ordinary income.

The question of whether there was a sale or a lease of the water rights is to be determined according to the principles governing the field of oil and gas taxation. *Don C. Day*, 54 T.C. 1417, 1422 (1970). Thus an answer to our question will turn on whether petitioners have, under the agreement with Shell, retained an economic interest in the water covered by the agreement. *Wood* v. *United States*, 377 F.2d 300, 303-304 (C.A. 5, 1967). An economic interest occurs where a taxpayer has acquired, by investment, an interest in a natural resource in place, and secures, by some legal relationship, income, derived from extraction of the resource, which provides the taxpayer with a return of his capital. *Palmer* v. *Bender*, 287 U.S. 551, 557 (1934). Respondent contends that petitioners retained an economic interest in the water in place, because payments under the agreement were based on production, and a reversionary interest was kept by petitioners. The facts do not support respondent's contention.

The agreement makes clear that Shell acquired the right to all the water between 3,000 and 6,500 feet under petitioners land. The only limitation on the grant was that petitioners reserved the right to so much of the water as might be required in producing minerals from the land in question. This small reservation makes the grant of the water no less complete. *Don C. Day*, *supra*, at 1424.

No down payment was called for by the agreement. The purchase price is required to be paid in monthly

installments over a period of 75 years. The monthly installments are not of a fixed amount, but rather are determined according to water produced by Shell from not only petitioners' land but also certain specified lands in the surrounding area, and according to the flow through any pipeline Shell might construct over petitioners' land. It has been said that "A bare right measured by production does not constitute an economic interest." *Commissioner* v. *Remer*, 260 F.2d 337, 340 (C.A. 8, 1958), affirming 28 T.C. 85 (1957). This principle applies *a fortiori* where the right is measured not only by production from the water rights transferred by the agreement under consideration, but also by production from other sources and by the mere transit of water through pipelines. On occasion the absence of a substantial down payment has been seen as an indication that a transaction is a lease rather than a sale. E.g., *Puckett* v. *Commissioner*, 355 F.2d 551 (C.A. 5, 1966), affirming per curiam a Memorandum Opinion of this Court. However, there is no general requirement under the Code that there be a sizable or any down payment for a transaction to qualify as a sale. Cf. section 453. Here, an economic interest in the natural deposit was not retained; the absence of a down payment is without major significance.

A taxpayer having an economic interest must not only look to extraction of the natural deposit for the return of his capital, but he must rely solely on that source. *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 314 (1956). In this case the amounts to be paid under the agreement were determined not according to water produced by Shell from petitioners'

land but from water produced by Shell from surrounding lands, and water transported through any pipelines constructed pursuant to the agreement. Thus the payments due under the agreement were not directly related to production from the water rights covered by the agreement. Indeed, to date Shell has undertaken no production of water from petitioners' land although, during the years in issue, petitioners received payments each year. So it is clear that petitioners were not looking solely to exploitation of the water for a return of their capital. In the agreement Shell explicitly stated that its intention was to obtain a water reserve. There was no specific requirement that Shell undertake production from the water rights granted. These facts fortify the conclusion that petitioners' were not attempting to secure exploitation of the water rights but rather conveyed the water in place. *Maude W. Olinger*, 27 T.C. 93, 97 (1956).

The agreement gives Shell the option of abandoning the water rights if the water from sources upon which the monthly purchase price payments are determined averaged less than 50,000 barrells per day for 6 months. Since the petitioners have not retained an economic interest in the water in place, the presence of a reverter clause such as this is not inimical to a conclusion that petitioners effected a sale rather than a lease of the water underlying their land. See *Helvering* v. *Elbe Oil Land Co.*, 303 U.S. 372 (1938); *Don S. Day, supra*, at 1427.

Respondent also contends that petitioners did not sell Shell an easement but rather only leased a right of

way. We note, however, that although the amount of each monthly payment was not fixed, the duty to make payments is to terminate on a specified date after which Shell will continue in possession of the easement. Thus Shell was acquiring a permanent interest in the property for the payments made. *Quartzite Stone Co.*, 30 T.C. 511, 518 (1958), affirmed 273 F.2d 738 (C.A. 10, 1959). In any event the transfer of the easement was an indivisible part of the agreement with Shell, and this Court will not split it off to produce an artificial result for the taxation of the proceeds received under the agreement. *A. C. Burton & Co.* v. *Commissioner*, 190 F.2d 115, 118 (C.A. 5, 1951), reversing on the facts 14 T.C. 290 (1950); *Western Wine & Liquor Co.*, 18 T.C. 1090, 1096 (1952). So we determine that in 1963 petitioners sold an easement as well as water rights to Shell, and that the payments received in 1965, 1966, and 1967 pursuant to the agreement are taxable as capital gains.

In accordance with the foregoing,
Decision will be entered under Rule 50.

APPENDIX "B"

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 72-2283

EARL VEST and FAY VEST,
Petitioners-Appellees-
Cross Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant-
Cross Appellee.

Appeals from a Decision of the Tax Court of the United States (Texas Case)

(June 22, 1973)

Before GEWIN, SIMPSON and RONEY,
Circuit Judges.

GEWIN, Circuit Judge: This appeal is from a decision of the Tax Court holding (1) that the grant of underground water rights by taxpayers, Earl and Fay Vest, was a sale and the proceeds were entitled to

capital gains treatment and (2) that payments received by the Vests for the grant of various surface rights incident to a mineral lease were in the nature of rent and hence were taxable as ordinary income. The Commissioner appeals from the Tax Court's characterization of the proceeds from the water rights grant and the taxpayers cross-appeal from the ruling on the surface rights payments. We reverse in part and affirm in part.

I. Water Rights

The Vests owned certain acreage in Winkler County, Texas including the water and mineral rights incident to that property. Prior to April 1963, Shell Oil Company approached them with a proposal to purchase their water rights together with a right of way to facilitate their development. Shell's chief reason for seeking this agreement was to obtain sufficient reserves to provide water for use in the secondary recovery of oil by means of waterflooding.[1]

On April 29, 1963 a final contract was executed. The Vests transferred to Shell by warranty deed the rights to all water between the depths of 3,000 and 6,500 feet

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[1]This is disclosed at the outset of the Sales Agreement between the Vests and Shell: "Shell is purchasing these water rights primarily to obtain sufficient reserves to develop to provide water economically to be used in the secondary recovery of oil by means of water floods in various counties in and about Winkler, Ector and Ward Counties, Texas, and such other endeavors as may from time to time require substantial quantities of water." Waterflooding is a method of recovering oil by means of injecting water into the oil reservoir. See Day v. Commissioner, 54 T.C. 1417, 1420 (1970).

beneath certain described land in Winkler County, Texas save that quantity of water needed by the Vests for their own exploration and production of minerals. Also transferred to Shell was a right of way over the Vests' land for the purpose of developing the acquired water rights and the construction, operation and maintenance of a trunk pipeline to be used to transport and distribute the water.[2]

Shell, in turn, agreed to make payments in monthly installments extending over a 75 year period although it was not required to pay any fixed amount. See Earl Vest, 57 T.C. 128 (1971). These payments, when they became due, were computed according to Shell's receipts from the sale of "purchase price water."[3] Pur-

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[2]Paragraph 2(A) of the Sales Agreement indicates plainly that the transfer of the right of way was not a separate and distinct transaction:

> Incidental to the grant of water rights contained in CONCURRENT CONVEYANCE Shell shall have the right of ingress and egress at all times for the purpose of exploring, prospecting, drilling for, and producing the water found in the rights thereby conveyed and removing the same to other lands, together with the right to construct, maintain and operate processing, purifying, demineralizing, and pumping plants, and fuel, power, telephone and gathering lines to and from them for handling and removing water from other lands within eight (8) miles of the affected plant as well as from the lands covered hereby, said rights as to fuel, power and gathering lines to apply not only to the lands covered by CONCURRENT CONVEYANCE but also to the lands expressly excepted therefrom by provision therein . . .

[3]Each monthly installment was to equal 13-1/6 percent of 3 percent of what Shell received for purchase price water during the month until 1.4 billion barrels of water were covered by the agreement then the amount due would rise to 13-1/6 percent of 6 percent of purchase price water.

chase price water was defined as water produced from the water rights transferred to Shell or from other water rights acquired by Shell from others in Winkler, Ward and Ector Counties, Texas, during April 1963, or from other specified areas of Winkler County that might be brought under the agreement at a later time, or any water, not otherwise covered by the agreement, transported through pipelines constructed pursuant to the agreement. Shell had the option of being relieved of any further liability under the agreement if the quantity of "purchase price water" fell below an average of 50,000 barrels per day for six months. In that event, Shell could transfer the acquired water rights back to the Vests and be relieved of any further obligation. However, even if this option were exercised, Shell still retained the right to utilize any pipeline which might have been laid on the Vests property, upon payment of an additional consideration, for the purpose of transporting substances other than water.[4]

From the date of the execution of the agreement through the tax years now in dispute (1965-1967), Shell did not drill any water wells, remove any water directly from the Vests' land or lay any pipeline. Nevertheless, Shell did pay the Vests a total of $26,630.95 for water extracted and transported from the property of neighboring landowners.[5] The Vests reported this in-

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[4]It should be noted that an additional consideration of $10 per rod of pipeline would be paid when this contingency occurred.

[5]The amount received by the Vests from Shell were reported as follows:

Year	Amount
1965	$ 4,545.80
1966	11,278.64
1967	10,806.51

come as capital gain received from the sale of the water rights and the right of way. Rejecting this determination, the Commissioner found that the Vests' transaction with Shell was a lease giving rise to ordinary income. Deficiencies were assessed accordingly.

The Tax Court, reversing the Commissioner's determination, held that the income received by the Vests with respect to the water rights and the right of way was capital gain, not ordinary income.[6] Applying the

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[6]Earl Vest, 57 T.C. 128 (1971). With respect to the Vest-Shell transaction the taxpayers urgently contend that the Tax Court correctly grasped and resolved the issues involved, although in argument it appears that the taxpayers tend to repudiate some of the descriptive terms used by the Tax Court. In reaching its decision the Tax Court specifically alluded to four separate factors and concluded that no one of them or a combination of all of them was sufficient to support the government's contention that the transaction resulted in a lease rather than a sale. The four factors mentioned and the conclusions reached are as follows:

1. There was a limitation on the grant to the extent that the petitioners *reserved* the right to a portion of the water. It was concluded that, "This small reservation makes the grant of the water no less complete."

2. There was no *down payment* but the court decided "there is no general requirement under the Code that there be a sizable or any down payment for a transaction to qualify as a sale. . . . Here, an economic interest in the natural deposit was not retained; the absence of a down payment is without major significance."

3. As to the *reversionary* interest of the taxpayers it was decided "Since the petitioners have not retained an economic interest in the water in place, the presence of *a reverter clause* such as this is not inimical to a conclusion that petitioners effected a sale rather than a lease of the water underlying their land." (emphasis supplied)

4. As to whether the taxpayers sold Shell an easement or only leased a right-of-way without *fixed payments* it was concluded: "We note, however, that although the amount of each monthly payment was not fixed, the duty to make payments

economic interest test approved by this court in *Wood v. United States*, 377 F.2d 300, 303-304 (1967) it rejected the Commissioner's assertions that the payments were based on production and that the Vests possessed a reversionary interest in the property.[7] Although the Tax Court acknowledged the relevance of such factors as the Vests' reservation of water rights for mineral exploration and the absence of either a fixed sales price or a substantial down payment, it did not regard them as controlling.[8] On the contrary, it found that the agreement between the Vests and Shell constituted a sale of the water in place and a permanent interest in the property for a right of way.[9] The Commissioner appeals from this part of the Tax Court's ruling.

Before reaching the merits of this question, there is a threshold issue which we must discuss briefly. The Commissioner contends that the economic interest test, *Palmer v. Bender*, 287 U.S. 551, 77 L.Ed. 489 (1933); *Commissioner v. Southwest Explor. Co.*, 350 U.S. 308, 314, 100 L.Ed. 347, 354 (1956), does not govern the tax consequences of the Vests' transfer of the water rights and the right of way. It is argued that this test was originally conceived to determine who has the depletable interest in minerals with re-

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is to terminate on a specified date after which Shell will continue in possession of the easement. Thus Shell was acquiring a permanent interest in the property for the payments made. In any event the transfer of the easement was an indivisible part of the agreement with Shell, and this Court will not split it off to produce an artificial result for the taxation of the proceeds received under the agreement." (citation omitted).

[7] Id. at 150.

[8] Id.

[9] Id. at 151.

spect to which the percentage depletion allowance is available. As such, the test is said to be a term of art ill-adapted to application outside the depletion context. The Commissioner cites several cases for this position. *Bryant v. Commissioner*, 399 F.2d 800, 806 (5th Cir. 1968); *Moberg v. Commissioner*, 365 F.2d 337, 340 (5th Cir. 1966) (Brown, J. concurring), but otherwise gives no concrete economic or scientific reasons to support it.

The view in this circuit is firmly established that the economic interest test can be applied to cases outside the percentage depletion area. "Although the 'economic interest' concept was developed and refined primarily in cases dealing with oil and gas law, we have observed that there is 'no apparent justification for a difference in approach depending on the nature of the mineral involved' . . . ." *Rutledge v. United States*, 428 F.2d 347, 350 (5th Cir. 1970). See also *Rhodes v. United States*, 464 F.2d 1307, 1310 (5th Cir. 1972); *Wood v. United States*, 377 F.2d 300, 304 (5th Cir. 1967). In the same vein, it has also been recognized on several occasions that regardless of the original purpose of the economic interest test, it is substantially the same as the test employed to determine whether income is taxable as capital gain or ordinary income. *Rutledge v. United States*, 428 F.2d 347, 351 (5th Cir. 1970); *Wood v. United States*, 377 F.2d 300, 305 (5th Cir. 1967). See *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25, 35, 90 L.Ed. 1062, 1069 (1946). In view of these principles, it appears to us that the Commissioner's argument in this connection is based on semantical distinctions and not considerations of economic or legal

substance. Hence, we conclude that the Tax Court's use of the economic interest test was not erroneous.[10]

As is always true in cases of this nature, a careful analysis of the facts is necessary to bring out the essential character of the transaction involved. A finding that an economic interest has been retained by the taxpayer must be supported by a showing of the following facts: (1) the taxpayer must have acquired by investment an interest in the minerals in place and (2) he must look solely to the extraction of the mineral for the return of his capital. *Commissioner v. Southwest Explor. Co.*, 350 U.S. 308, 314, 100 L.Ed. 347, 353 (1956); *Rhodes v. United States*, 464 F.2d 1307, 1310 (5th Cir. 1972). Since there can be no serious question about the Vests' pre-agreement investment interest in the water rights and right of way, our chief concern here will be to assess the Vest-Shell agreement in light of the second part of the economic interest test.

The case law relevant to this issue can be dichotomized into two broad yet distinct lines of authority: *sales* cases and *lease* cases. *Rhodes v. United States*,

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[10]We do not propose to delineate all of the possible ramifications, subtleties and intricacies of the economic interest test as it may be applied in numerous and varied transactions. It has wide application throughout many areas of tax law. We only conclude that the concepts developed with respect to the test constitute a valid and helpful analogy in the solution of the issue involved in this case. We must here determine whether proceeds arising out of agreements calling for the exploitation of natural deposits will be considered ordinary income or whether they will be taxed as proceeds from the sale of a capital asset. Accordingly we use the test as an aid in characterizing the transaction under consideration. See Wood v. United States, 377 F.2d 300, 304, 306 (5th Cir. 1967).

464 F.2d 1307, 1310 (5th Cir. 1972); *Wood v. United States*, 377 F.2d 300 (5th Cir. 1967). As a general proposition, if a sale is consummated, the taxpayer divests himself of all economic interest in the minerals transferred and therefore is entitled to treat the proceeds as capital gain. By the same token, if the transaction is a lease or one where the taxpayer looks solely to the extraction of minerals for a return on his capital, then he must treat the proceeds as ordinary income. *Rhodes v. United States*, 464 F.2d 1307, 1310 (5th Cir. 1972); *Rutledge v. United States*, 428 F.2d 347, 381 (5th Cir. 1970). See also *Commissioner v. Southwest Explor. Co.*, 350 U.S. 308, 314, 100 L.Ed. 347, 353 (1956).

An exhaustive review of the "sales" cases is not necessary in order to identify the factors which distinguish them from the "lease" decisions. While the presence of language of sale has always been considered relevant, it is well recognized in both lines of authority that the labels or words used by the parties in forming their contract are not controlling. In short, the substance of a contract's terms and provisions will prevail over its form. *Rhodes v. United States*, 464 F.2d 1307, 1311 n.4 (5th Cir. 1972); *Rutledge v. United States*, 429 F.2d 347, 352 (5th Cir. 1970) (lease case). Thus, since this court's decision in *Crowell Land & Mineral Corp. v. Commissioner*, 242 F.2d 864 (5th Cir. 1957), it has consistently been held that a sale results where an agreement purports to transfer within a prescribed time period *all*, *Rhodes v. United States*, 464 F.2d 1307 (5th Cir. 1972); *Gowans v. Commissioner*, 246 F.2d 448 (9th Cir. 1957); *Day v. Commissioner*, 54 T.C. 1417 (1970), or a *specific, predetermined* quantity of min-

erals in place, *Rhodes, supra, Linehan v. Commissioner*, 297 F.2d 276 (1st Cir. 1961); *Gowans v. Commissioner, supra,* in exchange for a fixed consideration.[11] *Rhodes, supra; Day, supra.* See also *Bryant v. Commissioner*, 399 F.2d 800, 806 (5th Cir. 1968); *Commissioner v. Remer*, 260 F.2d 337 (9th Cir. 1958). The economic effect of an agreement exhibiting these terms is abundantly clear. Not only does the transferor part completely with his interest in the minerals in place, he also acquires a right to receive payments which is not dependent upon extraction by the transferee. There is thus a cashing in of an investment interest and capital gain treatment of the proceeds is appropriate.

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[11]There are a number of other factors which have appeared in these cases but have not by themselves been considered of controlling importance one way or the other. Reverter provisions are one example. While generally more prevalent in leases than sales, they are not necessarily incompatible with the latter. It has been held that if all of a specific, predetermined quantity of minerals are transferred, that which reverts is not the remainder of the mineral deposit sold but rather the seller's right to possession of the land from which it was extracted. See Crowell Land & Mineral Corp v. Commissioner, 242 F.2d 864, 866-67 (5th Cir. 1957); Don C. Day, 54 T.C. 1417, 1425-26 (1970). When a mineral deposit has been transferred to make way for the subsequent development of the land under which it lies, some courts have found that fact to be indicative of an intent to sell. See, *e.g.*, Rhodes v. United States, 464 F.2d 1037, 1311 (5th Cir. 1972); Linehan v. Commissioner, 297 F.2d 276, 277 (1st Cir. 1961). Finally, in the water rights cases, there is frequently a reservation by the transferor of a right to use water for certain purposes. Although in one case this reserved right was considered to be significant enough to affect the sales versus lease issue, Puckett v. Commissioner, 23 T.C.M. 238, 241 (1964), *aff'd per curiam* 355 F.2d 551 (5th Cir. 1966), that is not ordinarily the case. See Don C. Day, 54 T.C. 1417, 1424 (1970); Rev. Rul. 55-295. *Contra* Rev. Rul. 70-204.

The Vest-Shell agreement, despite its language of sale, does not lend itself to easy categorization. It is a borderline transaction for tax purposes reflecting in varying degrees both sale and lease characteristics. Nevertheless, after an analysis of its terms and provisions as a whole, *Albritton v. Commissioner*, 248 F.2d 49, 51 (5th Cir. 1957), we cannot conclude that this agreement is controlled by *Crowell* and subsequent "sales" decisions. In our opinion the Vest-Shell agreement differs significantly from the transactions involved in those cases. Because of these critical differences we find that the Vests retained an economic interest in the water rights and right of way transferred to Shell.

Under the terms of the agreement, the Vests did not transfer to Shell all of the water in place or a specific quantity thereof. Though this fact alone represents a key difference from the "sales" cases, it takes on increased importance in light of other provisions in the agreement. These provisions indicate that Shell had no intention of making an outright purchase of water payable in any event. On the contrary, Shell acquired the water rights primarily for use when needed to provide sufficient reserves for the secondary recovery by oil by means of waterflooding.[12] While Shell was obligated to make payments to the Vests in monthly installments over a 75 year period, it is important that Shell controlled the conditions under which this obligation arose. Shell was under no duty to extract any "purchase price water" at all and if it did not,

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[12]See note 1 *supra*.

the Vests would receive nothing. We do not think that these terms are equivalent to the quid pro quo that has traditionally been associated with a bona fide sales transaction or a cashing in of one's investment interest in property.[13]

But having found that the Vest-Shell agreement is fundamentally unlike the transactions in the *Crowell* line of decisions involving what were determined to be sales, it does not automatically follow that the Vests retained an economic interest in the water rights. We still must inquire whether the Vests looked to the extraction of the water for a return on their capital. *Palmer v. Bender*, 287 U.S. 551, 77 L.Ed. 489 (1933); *Commissioner v. Southwest Explor. Co.*, 350 U.S. 308, 100 L.Ed. 347 (1956); *Rutledge v. United States*, 428 F.2d 347 (5th Cir. 1970); *Wood v. United States*, 377 F.2d 300 (5th Cir. 1967); *Albritton v. United States*, 243 F.2d 49 (5th Cir. 1957). See also *United States v. White*, 401 F.2d 610 (10th Cir. 1968) (en banc). This is the critical determination. The language of the contract relevant to this point is clear and unambiguous. The Vests possessed the right to be paid a percentage of the proceeds received by Shell from the sale of all "purchase price water" which by definition included but was not limit-

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[13]In reaching this conclusion, we have, of course, taken into account (1) Shell's right to reconvey free of any further liability in the event that the "purchase price water" dropped below a certain level of output and (2) the Vests' reservation of a right to use such water as may be necessary for mineral exploration in their own right. Neither provision, in our opinion, is a controlling consideration to a proper disposition of this aspect of the case. See note 11 *supra*.

ed to water actually extracted from wells situated on the Vests' property.[14]

We recognize that a "bare right measured by production does not constitute an economic interest," *Commissioner v. Remer*, 260 F.2d 337, 340 (8th Cir. 1958); *Rutledge v. United States*, 428 F.2d 347, 351 (5th Cir. 1970). But it is also true that "the question in all cases is what is owned by whom, or more exactly, what is the source of the right pursuant to which payments are received." *Bryant v. Commissioner*, 399 U.S. 800, 806 (5th Cir. 1968). Here we need only to emphasize what was pointed out earlier. The Vests' right to receive payments was linked inextricably to Shell's withdrawal of water or use of the pipelines. Without the occurrence of one or both of those eventualities, Shell incurred no liability whatever. This symbiotic relationship — between payments and production — is the kind of retained interest which makes the Vest-Shell agreement incompatible with a sale and more in the nature of a lease. Hence, we think the conclusion is inescapable that the Vests retained an economic interest in the water rights transferred to Shell. It follows that the proceeds from this transaction were ordinary income and that the Tax Court's conclusion to the contrary was error.[15]

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[14]See note 3 *supra*.

[15]The Vests contend that even if the proceeds from the water rights grant are found to be ordinary income, capital gains treatment should still be given to that part of the proceeds allocable to the right of way. But as we indicated earlier in note 2 *supra*, the grant of the right of way was a necessary part of this transaction, the primary purpose of which was to secure the water rights. Thus, under the circumstances of this case, there is no basis for treating each as a separate grant for income tax purposes.

II. Surface Rights

The second issue on this appeal concerns a lease agreement between the Vests and Standard Oil. Under its terms, the lease, which was executed in 1965, was to run for five years and as long thereafter as gas, oil and other minerals were produced from the land.[16] Paragraph 10 of this lease is the specific provision now in question; it required that Standard make payments to the Vests for well locations, tank batteries, flowlines and roads all of which were surface rights necessary to the exploration of the mineral rights acquired.[17] For the tax year 1965, the total amount of these payments was $33,422.[18]

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[16]Earl Vest, 57 T.C. 128, at 147 (1971).

[17]The relevant portion of Paragraph 10 reads as follows:

> It is understood and agreed that if and when exploratory, development or producing operations are conducted on the above described land, lessee, its successors and assigns, for the surface easement herein granted, shall pay to the surface owner at Kermit, Texas, on demand $150.00 per well location, $50.00 per tank battery site, $50.00 for each single shot hole, $150.00 for each multiple shot hole pattern in connection with seismograph or kindred operations on the land covered hereby, and $5.00 per linear rod for roads constructed and for pipelines laid (pipelines interconnecting storage tanks in the same tank battery and flow lines from a well to a tank battery at the site of that particular well shall not be considered pipelines for the purpose hereof).

[18]Standard's payments were allocated in the following manner:

1.	Well locations at $150 each	$1,650
2.	Tank batteries at $50 each	100
3.	Flowlines and Roads at $5 per rod	31,672
		$33,422

The Vests assert that these payments should be given capital gain treatment because they were to last for an indefinite period and their purpose was to restore the depreciation in the surface value of the property caused by Standard's mineral exploration. We reject this argument on both scores.

First of all it is not entirely accurate to suggest that Standard's payments were to last for an indefinite period. Despite the fact that no one can say precisely when they will terminate, it is, nonetheless, indisputable that they will terminate eventually, if for no other reason, because of the exhaustion of the minerals subject to the Standard lease. The reason, of course, is that once this occurs the purpose of the surface rights will cease to exist. All payments would end and the surface rights would revert to the Vests or their successors in interest. In light of these considerations, the Vests' restoration of capital loss argument has a hollow ring.

A brief reference to Paragraph 10 of the lease serves to confirm these doubts. It reveals that Standard agreed to pay the Vests for all *actual* damage caused to the surface of their property, *independent* of its obligation to pay for the well locations, tank batteries, flowlines and roads.[19] Were we to accept the Vests'

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[19]Paragraph 10 states in relevant part:

> Payment of said sums shall be in full payment for the surface rights in connection with the herein enumerated operations, but, lessee, all successors and assigns, shall be and remain liable to the surface owner and to lessor for any actual damage caused by lessee, and all successors and assigns, to the surface of said land and water therein and thereon, grass, vegetation and growing crops thereon, and

interpretation of this paragraph, it would mean either that the Vests were entitled to be compensated twice for capital loss or that Standard's duty to reimburse for actual damages was superfluous language without any legal significance. This position is patently untenable. We are compelled to conclude that Standard's payments for the surface rights were in the nature of rental income, *Lindley's Trust No. 1 v. Commissioner*, 120 F.2d 998, 1000 (8th Cir. 1941), and accordingly that there was no error in the decision of the Tax Court to this same effect.

The decision of the Tax Court is reversed in part and affirmed in part.

REVERSED IN PART; AFFIRMED IN PART.

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livestock operations thereon of the surface owner or occupier, occasioned by neglect or unreasonable use of said surface of the above described land, on demand, at Kermit, Texas, in the respective amounts above set out.

APPENDIX "C"

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

October Term, 1972

No. 72-2283

T. C. Docket No. 3726-69

EARL VEST and FAY VEST,
Petitioners-Appellees-Cross
Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant-Cross
Appellee.

Appeals from a Decision of the Tax Court of the United States (Texas Case)

Before GEWIN, SIMPSON and RONEY,
Circuit Judges.

JUDGMENT

This cause came on to be heard on the Transcript of the record of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the decision of the said Tax Court in this cause be, and the same is hereby reversed in part and affirmed in part;

It is further ordered that petitioners-appellees-cross appellants pay to respondent-appellant-cross appellee the costs on appeal to be taxed by the Clerk of this Court.

June 22, 1973

Issued as Mandate:

APPENDIX "D"

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 72-2283

EARL VEST and FAY VEST,
Petitioners-Appellees-
Cross Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant-
Cross Appellee.

Appeals from a Decision of the Tax Court of the United States (Texas Case)

ON PETITION FOR REHEARING AND PETITION FOR REHEARING EN BANC
(Opinion June 22, 1973, 5 Cir., 1973, ____ F.2d ____).

(August 8, 1973)

Before GEWIN, SIMPSON and RONEY,
Circuit Judges.

PER CURIAM: The Petition for Rehearing is DENIED and no member of this panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc, (Rule 35 Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 12) the Petition for Rehearing En Banc is DENIED.

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SUPREME COURT, U. S.

No. 73-517

Supreme Court, U. S.
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In the Supreme Court of the United States

OCTOBER TERM, 1973

EARL VEST AND FAY VEST, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

ROBERT H. BORK,
Solicitor General,
Department of Justice,
Washington, D. C. 20530.

In the Supreme Court of the United States

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1. For an indeterminate price, petitioners transferred to the Shell Oil Company the right to extract an indeterminate amount of water from under their land. Reversing the Tax Court, the court of appeals held that the agreement transferring the water rights was a form of lease so that the payments received by petitioners were taxable as ordinary income.[1]

[1] The court of appeals also held that certain other payments received by petitioners for surface rights were taxable as ordinary income (Pet. App. B 25a-27a). Petitioners, however, have not sought review by this Court of that aspect of the decision.

Under the agreement, petitioners transferred to Shell the right to extract water between 3,000 and 6,500 feet under their land, together with a right-of-way over the surface to enable Shell to construct and maintain a pipeline. Neighboring landowners entered into similar agreements with Shell. Whether Shell would need the water, and how much, were speculative matters since it acquired the water rights only as a reserve for possible secondary recovery of oil by water flooding. Shell did not obtain the right to extract all of the water at the specified depths, for petitioners reserved a paramount right to use as much of the water as they found necessary for mineral exploration. The volume of production was entirely within the control of Shell and it was not obligated to extract any water at all. Even if Shell commenced taking water, it could at any time reconvey to petitioners, free of liability, the water rights at issue, if production fell below a certain level, an event which Shell was free to arrange (Pet. App. B 13a-15a).

The agreement did not require Shell to make any fixed payment for the water rights. Rather, Shell undertook only to make payments based on specified percentages of its receipts from sales of water (or based on a percentage of the value of the water it used) where the water was extracted from petitioners' land or from neighboring lands, or was transported through any pipeline which it might construct over the lands involved. The payments (if any) were to be spread over a period of 75 years. If Shell did

not extract or transport water as described, petitioners would receive nothing (Pet. App. B 14a-15a).

During the taxable years at issue, Shell did not drill any water wells or construct any pipeline on petitioners' land. It did, however, pay petitioners approximately $26,600 for water extracted and transported from neighboring properties (Pet. App. B 15a).

2. The court of appeals correctly applied well-settled principles in holding that the payments received by petitioners were taxable as ordinary income from a leasing arrangement and not as capital gains from a sale. This Court has stated that the term "sale" is to be given its usual and ordinary meaning for purposes of taxation. *Commissioner* v. *Brown*, 380 U.S. 563, 571; *Helvering* v. *Flaccus Leather Co.*, 313 U.S. 247, 249. One of the prerequisites of a sale is that there be specific property transferred for a fixed price payable over a short term. *Iowa* v. *McFarland*, 110 U.S. 471, 478; *Bryant* v. *Commissioner*, 399 F. 2d 800 (C.A. 5); *Moberg* v. *Commissioner*, 365 F. 2d 337 (C.A. 5); *Nassau Suffolk Lumber & Supply Corp.* v. *Commissioner*, 53 T.C. 280.

Here, however, petitioners received no fixed consideration for the water rights payable over a short term. To the contrary, the payments they received were based entirely on receipts from water extracted from their land or from neighboring properties over a 75-year period. If Shell chose not to develop the properties, petitioners would receive nothing. Since

petitioners' right to payments was dependent upon Shell's extraction activities, there was not a transfer of a specific property interest for a fixed price.

Similarly, another essential element of a sale—that the transferor part completely with his ownership of specific assets—is lacking here. Petitioners' retention of an unlimited contractual right to any water necessary for mineral exploration, in effect a reversionary interest, is incompatible with a sale. *Puckett* v. *Commissioner*, 23 T.C.M. 238, 240-241, affirmed *per curiam*, 355 F. 2d 551 (C.A. 5).

3. Contrary to petitioners' argument (Pet. 10-14), the decision below does not conflict with *Anderson* v. *Helvering*, 310 U.S. 404, or its progeny of cases invoking the economic interest doctrine. Under this line of authority, a taxpayer is not entitled to a depletion allowance unless he has an economic interest in a mineral deposit. Such an interest is evidenced by an investment in the mineral in place with respect to which the owner is solely dependent upon extraction for a return of his capital investment.

If a transferor of mineral rights retains his economic interest by continuing to look solely to production for a return of his investment, the economic interest cases indicate that no sale has occurred but that the transfer is in the nature of a lease, the payments upon which are eligible for percentage depletion. *E.g.*, *Palmer* v. *Bender*, 287 U.S. 551; *Rutledge* v. *United States*, 428 F. 2d 347 (C.A. 5); *Oliver* v. *United States*, 408 F. 2d 769 (C.A. 4); *Belknap* v. *United States*, 406 F. 2d 737 (C.A. 6);

United States v. *White*, 401 F. 2d 610 (C.A. 10); *Hair* v. *Commissioner*, 396 F. 2d 6 (C.A. 9); *Royalton Stone Corp.* v. *Commissioner*, 379 F. 2d 298 (C.A. 2), certiorari denied, 389 U.S. 978; *Wood* v. *United States*, 377 F. 2d 300 (C.A. 5), certiorari denied, 389 U.S. 977; *Rabiner* v. *Bacon*, 373 F. 2d 537 (C.A. 8); *Freund* v. *United States*, 367 F. 2d 776 (C.A. 7). Conversely, if the transferor does not look solely to production for the consideration payable on the transfer and the transfer is of a fixed amount of minerals for a fixed price, the arrangement will be considered a sale taxable as capital gain, the proceeds of which are not eligible for percentage depletion. *Anderson* v. *Helvering*, *supra*; *Gowans* v. *Commissioner*, 246 F. 2d 448 (C.A. 9).

Petitioners contend that because they were to be paid by Shell not only out of production from their own land but also out of production and transportation of water extracted from neighboring properties, they did not retain an economic interest and hence made a sale. By so arguing, petitioners assume that the economic interest doctrine applies to non-depletable minerals such as water,[2] notwithstanding that the economic interest cases, including *Anderson*, involve only depletable minerals. But even under petitioners' theory that the economic interest doctrine is determinative of this case, the court of appeals did not conclude, contrary to *Anderson*, that petitioners had an economic interest in the water rights

[2] Section 613(b)(7) of the Internal Revenue Code of 1954 excludes water from the percentage depletion allowance.

at issue. To the contrary, it simply observed (Pet. App. B 19a, n. 10) that the economic interest concept was "a valid and helpful analogy in the solution of the issue involved in this case."

While we agree with petitioners that they did not have an economic interest in the water underlying the neighboring property within the meaning of *Anderson*, that case itself points out that the application of the economic interest test is only one factor in determining whether a sale of mineral rights occurred. Unlike this case, *Anderson* involved a sale of specific assets which were irrevocably conveyed for a fixed price, payable in any event. Here, however, where both the amount of minerals and the consideration payable therefor were indeterminate and the transferor maintained a significant reversionary interest in the minerals, petitioners cannot persuasively contend that a sale of their water rights occurred solely because Shell undertook to make payments measured by the water extracted from the adjoining property. Such payments are analogous to delay rentals—"amount[s] paid for the privilege of deferring development of * * * [petitioners'] property" —which are taxable as ordinary income, and ineligible for the depletion allowance. See Treas. Reg., 26 C.F.R., § 1.612-3(c)(1) and (2).

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

NOVEMBER 1973.

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